No. 93-489 (13)

IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

O'MELVENY & MYERS,
A LAW PARTNERSHIP,
Petitioner,

v.

FEDERAL DEPOSIT INSURANCE CORPORATION, AS RECEIVER FOR AMERICAN DIVERSIFIED SAVINGS BANK, ADC FINANCIAL CORPORATION, AMERICAN DIVERSIFIED/WELLS PARK II, AND AMERICAN DIVERSIFIED/GATEWAY CENTER,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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BRIEF AMICUS CURIAE OF BANKING AND BUSINESS LAWYERS IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether it is appropriate to create a federal common law rule that retroactively alters traditional principles of attorney professional liability solely for the purpose of maximizing the asset pool of a federal agency.

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BRIEF AMICUS CURIAE OF BANKING AND BUSINESS LAWYERS IN SUPPORT OF PETITIONER

INTEREST OF AMICI CURIAE

The undersigned *amici curiae* are banking and business lawyers from all over the United States each of whom has many years of experience in representing federally insured depository institutions ("IDIs") and their holding companies and affiliates. *Amici* have been active in organized Bar activities at the State and local level as

well as at the national level, including the Federal Bar Association and the American Bar Association ("ABA"),[1] and are committed to the provision of the highest quality legal services consistent with the best ethical traditions of the profession. *Amici* have been actively involved in the study, discussion, and debate—whether in print or in private or public fora—of ethical and policy questions concerning the duties of counsel representing IDIs that have arisen in the wake of the failure of thousands of such institutions during the 1980's and 1990's. The issues presented in this case directly address the role that lawyers play in the administration of justice when serving as counsel for a wide variety of business entities, including federally and state-chartered commercial banks, savings banks, savings and loan associations, as well as thrift and loan companies, industrial loan companies, credit unions, and the like.

Here the Federal Deposit Insurance Corporation ("FDIC"), acting as statutory successor to the defunct Federal Savings and Loan Insurance Corporation ("FSLIC"),[2] wishes to impose malpractice liability upon a law firm (in this case the firm of O'Melveny & Myers ("O'Melveny")) when, unbeknownst to the law firm, its client had perpetrated a fraud upon third parties. In the wake of the savings and loan debacle and the FSLIC insolvency, FDIC and its counterpart, the Resolution

[1] Although many of the *amici* have been extremely active in the ABA and various other bar associations, and several chair Committees, Subcommittees, and Task Forces thereof, this brief is not being sponsored or filed by any of those organizations and does not necessarily represent their views.

[2] As correctly noted by the court below, the Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (1989) ("FIRREA"), *inter alia* abolished the FSLIC, transferred its assets and liabilities to the FSLIC Resolution Fund (managed by FDIC), and caused FDIC to be substituted for FSLIC as the party in interest in cases of this kind.

Trust Corporation ("RTC"),[3] have come under increased scrutiny and political pressure from Capitol Hill to speed up the process of resolving failed institutions and recover damages from wrongdoers to defray the enormous public expense of the thrift bailout. This case is one of a series of cases brought by FDIC or RTC involving claims—typically arising under State tort or contract law—against professionals (including attorneys and accountants) where the same State law that creates the cause of action would either bar the claim or give rise to certain affirmative defenses but where the FDIC, in order to avoid this result, asks the court to disregard State law and create a new federal common law rule of decision that would resuscitate an otherwise barred claim or negate established State law defenses. In many instances, as here, the result is to create new duties and obligations which do not exist under State law, certainly did not exist at the time of the conduct complained of, and were unforeseeable by the professional firms involved.

Amici are concerned about the threat to our system of State regulation of the Bar—and indeed to the attorney-client relationship itself—posed by the sort of selectively and retroactively imposed liability "legislated" by judges under the putative authority of federal common law, as exemplified by this case. If the mere presence of FDIC as receiver in a case can change the controlling law governing professional liability, then counsel for IDIs would feel themselves obliged to be looking over their own shoulders every time they are called upon to provide legal services. Worse yet, the imposition of a separate duty owed by counsel to constituencies other than the client raises the spectre of conflict of interest in even routine transactions. There would, in short, be a chilling

[3] RTC is a mixed ownership government corporation created by Congress in FIRREA for the purpose of managing and resolving IDIs previously insured by FSLIC. In general, RTC and FDIC enjoy the same case resolution rights and powers.

effect on the ability of the banking bar to provide totally disinterested advice and to represent their clients zealously.

Moreover, the cost and availability of legal services to IDI clients would be adversely affected. Even if the proliferation of claims against law firms does not, of itself, impel a number of firms currently providing legal services to IDIs to leave the market, the increasing cost and diminishing availability of malpractice insurance may lead to that result. Those firms that remain will, of necessity, be forced to charge higher fees for such services and may well find it prudent not to represent IDIs in financial difficulty or with low net worth because of the increased risk of failure and the appointment as receiver of an agency that feels compelled to look to every "deep pocket" as a potential defendant from which to recover money damages. Therefore, clients that need quality legal services the most may often be unable to find them or afford them if found.

These issues—lawyers' ethical obligations, the integrity of the attorney-client relationship, and the cost and availability of legal services—are of great concern to the legal profession, and the perspective of *amici* on these issues should be of assistance to the Court.[4] Moreover, apart from the impact of the decision below upon an individual law firm, the inappropriate fashioning of federal rules of decision to benefit the interests of a single, albeit frequent, litigant in the court system has broader ramifications for the administration of justice and therefore implicates core concerns of *amici*, who have considerable experience with both banking law and regulation[5] and the judicial process.

[4] This brief *amicus curiae* is filed with the consent of the parties. Copies of their consent letters are on file with the Clerk of the Court.

[5] Several of the amici have participated in two ABA-affiliated groups that have heretofore issued reports analyzing, *inter alia*, the responsibilities of counsel in the context of claims advanced by the federal bank regulators. *See* ABA WORKING GROUP ON LAWYERS' REPRESENTATION OF REGULATED CLIENTS, LABORERS IN DIFFERENT VINYARDS? THE BANKING REGULATORS AND THE LEGAL PROFESSION (Discussion Draft, Jan. 1993) [hereinafter "*Working Group Report*"]; CHAIRMAN'S EXPOSURE DRAFT, TASK FORCE ON THE LIABILITY OF COUNSEL REPRESENTING DEPOSITORY INSTITUTIONS (First Interim Report, Aug. 3, 1992), *reprinted in* 9 BANK AND CORPORATE GOVERNANCE LAW REPORTER 980 (1992) [hereinafter "*Task Force Report*"].

SUMMARY OF THE ARGUMENT

The court below, without analysis or even acknowledgment of this Court's recent federal common law jurisprudence, disregarded the legitimate interests of the States in regulating the professional conduct of lawyers and created a novel federal common law duty that disrupts commercial relationships between lawyers and their clients. In so doing, the court ignored State law defenses which California allows defendants to interpose against the State law claim brought by FDIC herein, all for the sole, avowed purpose of maximizing FDIC's recoveries in litigation.

The duty created by the court below is not only unprecedented but also ill-conceived. A duty by an IDI's counsel to depositors or to the government muddies the duty of undivided loyalty to the client and threatens to create conflicts in a large number of routine transactions. It will also have a chilling effect on counsel's ability to represent an IDI client in "cutting edge" transactions. Having to look over one's shoulder in fear of potential liability should the client fail and FDIC become receiver will impair that independence and detachment which are among the principal values of the attorney-client relationship.

Finally, the decision below has a deleterious impact on the availability, cost, and coverage of legal malpractice insurance and, as a consequence, on the cost and availability of legal services to IDIs. The long-term costs of

disrupting settled professional and commercial expectations heretofore governed by State law far outweigh any short-term benefit to the taxpayers from maximizing FDIC's asset pool.

ARGUMENT

I. REGULATION OF THE LEGAL PROFESSION IS TRADITIONALLY WITHIN THE PURVIEW OF THE STATES.

At the request of a single, albeit frequent, litigant habitually claiming broad powers to act in the public interest, the court below fashioned a novel duty of counsel—despite the lack of any basis for suspicion—to investigate and discover whether an IDI client is engaging, or has engaged, in fraudulent activities and, if so, to disclose the same to potential investors. Purporting to rely on California law as the source for this duty, the court in fact cited no California authority whatever for such a proposition and instead created a duty predicated on *federal* law. The court then went on to create federal rules of decision to deprive O'Melveny of State law defenses against FDIC's malpractice claims, because "federal, not state, law governs the application of defenses against FDIC," Pet. App. 13a, FDIC did "not voluntarily step into [ADSB's] shoes" but "was thrust into them," *id.* at 14a, and allowing the State law defenses would diminish the value of FDIC's asset pool, *id.* at 15a.

In so doing, the court below ignored the legitimate interests of the States in regulating the professional conduct of lawyers, ignored the principles of State law that establish the duty of counsel, ignored the defenses which the State allows defendants to interpose against the claim brought by FDIC that itself sounds in State tort law, and ignored this Court's decisions expounding on federal common law and the propriety of creating it.

This Court has frequently recognized

> that the States have a compelling interest in the practice of professions within their boundaries, and that as part of their power to protect the public health, safety, and other valid interests they have broad power to establish standards for licensing practitioners and regulating the practice of professions * * * * The interest of the States in regulating lawyers is especially great since lawyers are essential to the primary governmental function of administering justice, and have historically been "officers of the courts." [*Goldfarb v. Virginia State Bar,* 421 U.S. 773, 792 (1975), citing *Sperry v. Florida ex rel. Florida Bar,* 373 U.S. 379, 383 (1963); *Cohen v. Hurley,* 366 U.S. 117, 123-124 (1961); *Law Students Research Council v. Wadmond,* 401 U.S. 154, 157 (1971).]

The testing, licensing, and admission to practice of a lawyer, the standards of professional conduct governing the practice of law, and the enforcement of those standards by appropriate disciplinary proceedings are all under the control of the States and their respective judiciaries. "[T]he regulation of the activities of the bar is at the core of the State's power to protect the public," *Bates v. State Bar of Arizona,* 433 U.S. 350, 361 (1977), and is "a sovereign function of the [State's] Supreme Court." *Hoover v. Ronwin,* 466 U.S. 558, 569 n.18 (1984).[6]

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[6] Indeed, though its luster has dimmed since this Court's decision in *Garcia v. San Antonio Metro. Transit Auth.,* 469 U.S. 528 (1985), the Tenth Amendment is still thought by important scholars to be the Constitution's expression of protection for such traditional State functions and essential attributes of State sovereignty. *See, e.g.,* William Van Alstyne, *The Second Death of Federalism,* 83 MICH. L. REV. 1709 (1985). It is one thing for the Congress, a representative and politically accountable branch of government, to intrude into this realm by legislation; it is quite another for the federal judiciary to intrude by creating federal common law.

II. THERE IS NO BASIS IN LAW FOR THE CREATION OF A FEDERAL COMMON LAW DUTY TO INVESTIGATE

Explicit in this Court's decisions from and including the landmark *Erie* decision is that statutes granting federal jurisdiction do not constitute enabling authority for a federal court to make federal common law and that there must be some separate source of authority for such a rule. *See, e.g., Texas Indus., Inc. v. Radcliff Materials, Inc.*, 451 U.S. 630, 640-41 (1981). This principle has both a constitutional and a statutory dimension.[7] In the words of Justice Brandeis:

> Except in matters governed by the Federal Constitution or by Act of Congress, the law to be applied in any case is the law of the State * * * * There is no federal general common law. Congress has no power to declare substantive rules of common law applicable in a State whether they be local in nature or "general," be they commercial law or part of the law of torts. And no clause in the Constitution purports to confer such a power upon the federal courts * * * * "Supervision over either the legislative or the judicial action of the States is in no case permissible except as to matters by the Constitution specifically authorized or delegated to the United States. Any interference with either, except as thus permitted, is an invasion of the authority of the State and, to that

[7] The statute is the very one at issue in *Erie* itself, the Rules of Decision Act, which currently provides, "The laws of the several states, except where the Constitution or treaties of the United States or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the courts of the United States where they apply." 28 U.S.C. § 1652 (1982). The only textual difference between this language and the original version in the Judiciary Act of 1789 is that the Act now extends to "civil actions" rather than merely to "trials at common law." The explicit reach of the statute has thus been expanded since original passage, though the case at bar, sounding in common law tort, would have been covered by the earlier version as well.

> extent, a denial of its independence." [*Erie R. v. Tompkins*, 304 U.S. 64, 78-79 (1938) (quoting *Baltimore & O.R.R. v. Baugh*, 149 U.S. 368, 401 (1892)).][8]

In *United States v. Kimbell Foods, Inc.*, 440 U.S. 715, 728-729 (1979), this Court established a three-pronged test for creating federal common law: (i) whether the court is dealing with federal programs that "by their nature are and must be uniform in character throughout the Nation"; (ii) whether application of State law would frustrate specific objectives of the federal program; and (iii) whether application of a federal rule would not disrupt commercial relationships predicated on State law. None of these criteria is triggered in a case involving a malpractice claim by the assignee of a California state-chartered IDI against a law firm that represented state-chartered subsidiaries of the IDI.

A. Bank Receiverships Are Not A Federal Program Requiring Uniformity

The mere existence of a scheme of federal regulation does not give rise to a need for uniformity. Even as comprehensive a scheme as the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.*, which confers regulatory power to one federal agency but does not expressly deal with prior demand in a derivative action under State corporate law, was not regarded by this Court as justifying the creation of federal common law that does not incorporate the State law rule. *Kamen v. Kemper Fin. Serv., Inc.*, 111 S. Ct. 1711 (1991). Banking regulation presents an *a fortiori* case, inasmuch as Congress has long

[8] *Accord Texas Indus., Inc. v. Radcliff Materials, Inc.*, 451 U.S. 630, 641-642 (1981) (federal courts may not fashion federal common law rule of contribution even under antitrust laws—a federally created cause of action—because, while there is a federal interest in the appropriateness of contribution, this is not the type of "uniquely federal interest" that would support federal common law).

recognized—and left intact—a dual system of regulation by the states and by not one, but several, federal agencies, where in many instances the latter—and even federally created IDIs such as national banks—are bound by State law restrictions.[9]

Congress has the power to alter this scheme and has done so in specific instances. For example, in FIRREA Congress amended the Federal Deposit Insurance Act, 12 U.S.C. § 1811 *et seq.*, to preempt State law (A) that might otherwise forbid or impede FDIC from effecting emergency acquisitions of failing IDIs[10] or from accepting appointment to act as conservator or receiver for any IDI;[11] (B) that establishes a statute of limitations of less than 6 years for contract claims or 3 years for tort claims in actions brought by FDIC;[12] (C) that would

[9] Some examples, apart from obvious ones such as chartering, supervision and examination, are the "competitive equality" effected by the McFadden Act, 12 U.S.C. § 36(c), between the branching powers of national and state banks, *see First Nat'l Bank in Plant City v. Dickinson*, 396 U.S. 122 (1969); *First Nat'l Bank of Logan v. Walker Bank & Trust Co.*, 385 U.S. 252 (1966); exercise of fiduciary powers by national banks when not in contravention of State law, 12 U.S.C. § 92a(a); and state power to override the prohibition in the Douglas Amendment to the Bank Holding Company Act, 12 U.S.C. § 1842(d), against interstate ownership of banks by bank holding companies, *see Northeast Bancorp. v. Board of Governors*, 472 U.S. 159 (1985); *Whitney Nat'l Bank v. Bank of New Orleans & Trust Co.*, 379 U.S. 411 (1965).

[10] FIRREA § 217(8), adding a new subsection (k) to § 13 of the Federal Deposit Insurance Act, 12 U.S.C. § 1823(k).

[11] FIRREA § 212(a), amending § 11(c) of the Federal Deposit Insurance Act, 12 U.S.C. § 1821(c).

[12] FIRREA § 212(a), adding subsection (d)(14) to § 11 of the Federal Deposit Insurance Act, 12 U.S.C. § 1821(d)(14).

In their zeal to maximize recoveries, both FDIC and RTC have frequently argued that § 11(d)(14) resurrects claims that have expired under State law prior to the conservatorship or receivership, but the lower federal courts have consistently rejected that position. *See, e.g., FDIC v. Regier, Carr & Monroe*, 996 F.2d 222

permit damages in excess of "actual direct compensatory damages" (*e.g.*, punitive damages, damages for pain and suffering) as liability for FDIC's repudiation of certain executory contracts.[13] Thus where Congress wanted uniformity, it enacted uniformity.

In contrast, while FIRREA contemplates professional liability suits by FDIC, nowhere in FIRREA or in any other statute has Congress created a comprehensive federal standard to govern such suits. To the contrary, FIRREA expressly contemplates the application of State law. For example, FDIC may seek to recover damages from directors and officers "for gross negligence, including any similar conduct or conduct that demonstrates a greater disregard of a duty of care (than gross negligence) including intentional tortious conduct, *as such terms are defined and determined under applicable State law*."[14]

B. Application of State Law Would Not Frustrate Specific Objectives of a Federal Program

From the foregoing, one can see that merely maximizing FDIC's recoveries or, in the words of the court below, "the value of FDIC's asset pool," Pet. App. 15a, however desirable for an agency under pressure from a deficit-conscious legislature, has never been seen by Congress as a justification for displacing State law. In providing additional powers to FDIC, Congress has been careful to limit preemption of State law to those situations where it would threaten the *orderliness of the process*. Thus protecting from State law challenge the agency's authority to effect last-minute, emergency acquisitions of

(10th Cir. 1993); *Randolph v. RTC*, 995 F.2d 611 (5th Cir. 1993); *FDIC v. McSweeney*, 976 F.2d 532 (9th Cir. 1992), *cert. denied*, 113 S. Ct. 2440 (1993); *RTC v. Greenwood*, 798 F. Supp. 1391 (D. Minn. 1992); *RTC v. Gardner*, 788 F. Supp. 26 (D.D.C. 1992).

[13] FIRREA § 212(a), adding new subsection § 11(e) to the Federal Deposit Insurance Act, 12 U.S.C. § 1821(e).

[14] FIRREA § 212(a), adding new § 11(k) to the Federal Deposit Insurance Act, 12 U.S.C. § 1821(k) (emphasis supplied).

failing IDIs, creating a federal statute of limitations so the receiver has adequate time to evaluate potential lawsuits and determine whether to bring them, and permitting the receiver to repudiate burdensome executory contracts entered into by a now defunct IDI without liability for exemplary damages are all reasonable accommodations designed to facilitate the *orderly resolution* of hundreds of failed institutions with billions of dollars of assets. That is the fundamental objective of this federal program. Creating federal common law to fill in the interstices of the Federal Deposit Insurance Act is only justified when it serves this objective.[15]

The facts of the instant case present no justification for creating federal common law. Three of the four business plaintiffs, those most closely involved with retaining O'Melveny as legal counsel, were state-chartered service corporations, partnerships, or joint ventures to which none of FIRREA's statutory provisions applies. These entities could not legitimately be placed in FSLIC or FDIC receivership but would be subject, if insolvent, to the federal bankruptcy code.[16] Moreover, when in 1986 FSLIC,

[15] Cases like *D'Oench, Duhme & Co. v. FDIC*, 315 U.S. 447 (1942), where this Court created a federal common law rule to protect the receiver from secret side agreements with borrowers not appearing on the books of the failed bank, and thereby jeopardizing the receiver's ability to bring about orderly resolution of the institution's assets and liabilities, are consistent with this overarching purpose.

[16] In fact, it is doubtful under this Court's precedents whether there is federal jurisdiction over these entities. *See Finley v. United States*, 490 U.S. 545 (1989); *Owen Equipment & Erection Co. v. Kroger*, 437 U.S. 365 (1978); *Aldinger v. Howard*, 427 U.S. 1 (1976). Lower courts have declined to exercise pendent party jurisdiction in contexts similar to the instant case. *See, e.g., Amerifirst v. Bomar*, 757 F. Supp. 1365, 1375 (S.D. Fla. 1991) (dismissing claims by IDI's service corporation subsidiary even though there was federal jurisdiction over suit by parent IDI). *Cf. FDIC v. Thompson & Knight*, 816 F. Supp. 1123, 1129 (N.D. Tex. 1993), *appeal pending*, Nos. 93-1378 & 93-646 (5th Cir., filed April 22, 1993) (FDIC lacks standing to bring or pursue claims of IDI's subsidiaries).

as conservator of ADSB, decided to pay off the investors/limited partners[17] in the two joint venture plaintiffs, American Diversified/Wells Park II and American Diversified/Gateway Center, the settlement funds came not from the assets of the thrift but from another first-tier subsidiary, American Diversified Capital Corporation (interestingly, not a plaintiff in this case) and were actually paid out not by ADSB but by ADC Financial Corporation, a general partner in the Wells Park and Gateway Center projects.[18] Thus the alleged contacts of entities properly implicated in any federal program with the transaction in question—the only transaction in which O'Melveny provided legal services—were at best remote.

C. Application of a Federal Rule Would Disrupt Commercial Relationships Predicated on State Law

The third prong of the *Kimbell Foods* analysis also militates strongly against the creation of federal common law in this case. While the practice of law itself is a profession and the relationship of attorney and client is special and subject to professional privilege, that relationship is also a commercial relationship: it is typically created via an engagement letter from the attorney to the client, acknowledged and agreed to by the latter, pursuant to which a fee will be paid for the attorney's services. Negligent performance by the attorney subjects

[17] These investors are not among the group Congress has specified to whose rights, titles, powers, and privileges FDIC may properly succeed; that group consists only of the IDI itself and "any stockholder, member, accountholder, depositor, officer, or director." 12 U.S.C. § 1821(d)(2)(A). So the Ninth Circuit's observation that "the receiver becomes the bank's successor as part of an intricate regulatory scheme designed to protect the interests of third parties," Pet. App. 14a, is a red herring: the court is dealing with the wrong third parties.

[18] These facts are as described by FDIC in Appellants' Opening Brief to the Ninth Circuit, at 9-11.

him to liability under State law, a risk against which the attorney normally carries malpractice insurance. In some States, the client's cause of action sounds in tort, in others it sounds in contract or even breach of warranty. The relationship between a large law firm and its client is no different from that of a solo practitioner and his or her client, and it makes no difference whether the client is an unsophisticated individual or a large corporation that is a frequent and savvy consumer of legal services; the standard of care is the same and the understanding between the parties as to the client's fee obligations and the duties and ethical obligations of counsel are all essentially the same. In all instances there is a commercial relationship predicated upon and governed by State law.

Here O'Melveny, whose principal office is in California, provided legal advice to the California-chartered subsidiaries of a California-chartered thrift institution. That legal advice presumably was based in large part on California law, including California corporate, partnership, and real estate law. The firm and the client each would safely have assumed, particularly in 1985, that O'Melveny's professional responsibilities were governed by the law of the State of California, which controlled admission, practice, supervision, and discipline of lawyers licensed and practicing in California.

There is simply no way O'Melveny—or any other law firm—could have rationally conducted its business on the assumption that, years later, its professional obligations to these state-chartered subsidiaries would become governed, upon the failure of the parent thrift, by novel federal law created by a federal court in 1992. Strikingly, even FDIC did not take the position that these 1985 relationships were governed by federal common law until filing its reply brief in the Ninth Circuit, and there the matter was alluded to only in footnotes.[19]

[19] Both in its opening brief (at pp. 40, 41, and 44) and its reply brief (at pp. 18-19, nn. 17-18) in the court below, FDIC characterized the legal issue, as it has, in effect, done before this Court in its Brief in response to the Petition for a Writ of Certiorari, as one of whether a federal agency receiver of a thrift "stands in the shoes of the thrift" for all purposes.

The claim advanced by FDIC in this case—legal malpractice—is a classic, State law tort claim. Like all tort claims, it requires the plaintiff to establish the breach of an actionable duty. The creation *post hoc* of a novel, federal common law duty that is not only different from, but at odds with, what lawyers have traditionally understood their responsibilities to be cannot help but disrupt the traditional relationships, predicated on State law, that lawyers and law firms everywhere have established with their clients for many years.

* * * *

In short, the court below, without citation or analysis of this Court's controlling decisions in *Kimbell Foods* and *Kamen*, has devised an unprecedented federal common law duty that intrudes into the States' traditional role as regulators of the legal profession and disrupts commercial relationships between lawyers and their clients. The court has done so at the request of a frequent litigant with a national litigation strategy, and for the avowed purpose of maximizing recoveries by that litigant, Pet. App. 15a. This reasoning is tantamount to providing a "volume discount" for a frequent customer, and the novel duty of counsel created is, in fact, a policy judgment Congress has declined to enact. It is also, as discussed below, a bad policy.

III. THE COURT OF APPEALS HAS CREATED AN UNPRECEDENTED AND UNWORKABLE DUTY OF COUNSEL

A. There is No General Duty to Investigate

"[O]f major concern to practicing lawyers is the scope of a duty of inquiry into the accuracy and reliability of

facts when rendering a legal opinion, documenting a transaction, participating in the follow-up to an examination, or generally representing a regulated client."[20] The Model Rules of Professional Conduct ("Model Rules") do not have a separate rule on this subject specifically, but relevant observations are scattered in several rules and comments.[21] The general statement most on point is in the comments to Rule 2.1:

> * * * A lawyer ordinarily has no duty to initiate investigation of a client's affairs or to give advice that the client has indicated is unwanted, but a lawyer may initiate advice to a client when doing so appears to be in the client's interest. [MODEL RULES OF PROFESSIONAL CONDUCT Rule 2.1 cmt ¶ 5.]

B. The Ninth Circuit's Federal Duty to Investigate is Ill-Conceived

The professional standards articulated by the Model Code of Professional Responsibility and the Model Rules, in their various State incarnations, impose upon the lawyer a duty, among others, of undivided loyalty to the client.[22] The lawyer must balance that duty with his

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[20] *Working Group Report*, note 5 *supra*, at 181. This concern has been raised not only in receivership litigation (as in the case at bar) but also in the context of several consent orders in administrative actions brought by the Office of Thrift Supervision ("OTS") against law firms. *Id.* at 181-182.

[21] *See, e.g.*, MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.2(a) (1983), directing a lawyer to "abide by a client's decisions concerning the objectives of representation" but subjecting the scope of representation to certain limits, most prominently the prohibition in Rule 1.2(d) against "counsel[ing] a client to engage, or assist[ing] a client in conduct that the lawyer *knows* is criminal or fraudulent" (emphasis supplied).

[22] This principle is not new. Nearly 60 years ago, a formal A.B.A. ethics opinion observed, "It cannot be proper for a lawyer to represent his client when the lawyer's own interests may tempt him to temper his efforts to promote to the utmost his client's

obligation, as an officer of the court, to uphold the law and our system of justice.[23] That balancing act forbids, for example, the lawyer from construing his duty of loyalty to the client as requiring (or permitting) counseling or aiding and abetting that client's commission of a crime or fraud.[24]

But this is a far cry from suggesting that a lawyer owes some sort of additional duty to the government when representing an IDI client that is already subject to pervasive regulation and supervision by agencies of the government.[25] Were such a duty to exist, then the lawyer would be disabled, in a potentially high percentage of engagements, from providing legal services to the client because of an inherent conflict of interest. Such a duty would, for example, require the lawyer representing an IDI in a "cutting edge" transaction to notify the regulator and seek to ascertain its position on the matter, an effort which is not, in general, required of the client or

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interests." A.B.A. Comm. on Professional Ethics and Grievances, Formal Op. 132 (Mar. 15, 1935). Similarly, Canon 15 of the A.B.A. Canons of Professional Ethics stated in part, "The lawyer owes entire devotion to the interest of the client, warm zeal in the maintenance and defense of his rights and the exertion of his utmost learning and ability, to the end that nothing be taken or be withheld from him, save by the rules of law, legally applied." Canon 7 of the Model Code of Professional Responsibility likewise requires the lawyer to represent the client's interest zealously, provided this is done within the bounds of the law. *See* MODEL CODE OF PROFESSIONAL RESPONSIBILITY Canon 7, DR 7-101 (1980). At the same time, however, the rule does permit the lawyer to exercise independent professional judgment and to refuse to aid or participate in conduct that he believes to be unlawful, even though there is some support for an argument that the conduct is legal.

[23] *See, e.g., id.* DR 7-102.

[24] *See, e.g.*, MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.2(d) (1983).

[25] In this case, ADSB was subject to regulation at *both* the federal and state levels.

the lawyer, and may not be desired by the client or even practical in view of the timing of most business transactions and the often protracted process of obtaining guidance from a government agency. Also, if the lawyer does ascertain the agency's position and finds that the agency disagrees with the client's and the lawyer's position, the lawyer will become entangled in an ethical quagmire. The Model Rules generally proscribe representing a client if the representation "may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests . . ." [26] While the rule does permit exceptions with client consent after full disclosure, that consent alone is insufficient, as the rule also requires that "the lawyer reasonably believes the representation will not be adversely affected" [27] —a judgment many lawyers will be unable to make if it is clear the government's and client's respective positions are irreconcilable.

The lawyer's position becomes even more difficult when the bounds of the duty to the government are expanded. Now the lawyer has reason to be concerned about his or her own liability if an enforcement action or malpractice claim asserting such a duty should subsequently be brought by the government. "The lawyer's own interests should not be permitted to have an adverse effect on representation of a client * * * * If the probity of a lawyer's own conduct in a transaction is in serious question, it may be difficult or impossible for the lawyer to give a client detached advice." [28]

[26] MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.7(b) (1983).

[27] *Id.* Rule 1.7(b)(1)-(2).

[28] *Id.* Rule 1.7, cmt. This fear is not theoretical. The General Counsel to one of the nation's largest banking organizations told the ABA Working Group on Lawyers' Representation of Regulated Clients that, with the proliferation of cases by the banking agencies against law firms, outside counsel have begun noticeably to "pull their punches" and are no longer taking as aggressive a stance with the regulators on the bank's behalf.

Lest it be thought that these concerns are far-fetched and that the agencies would never expect this new duty to be extended so far, it should be noted that not only FDIC but other federal regulators have already suggested pushing the concept far beyond what is implicit in the factual setting of the instant case. In one recent lawsuit, FDIC claimed that the defendant law firm failed to advise not only the board of directors of its client bank but also the federal regulator, with which it was negotiating on behalf of the client, that the law firm was intensively working, at the bank's expense, on a buyout by an insider and the financial arrangements for that buyout with foreign bank clients of the firm.[29] While the firm's failure to advise the board would seem to state a claim, it is by no means clear whence a duty arises to inform the regulator.[30] Additionally, among the claims of legal malpractice advanced in this complaint is that the firm "failed to exercise independent professional judgment on behalf of the Bank *and its depositors* * * * *" [31] While no one would quarrel with the theory of this claim as it applies to the bank, the notion that counsel to the institution are also representing the depositors is hardly an accepted one.

[29] *FDIC v. Eckert Seamans Cherin & Mellott et al.*, No. 90-0488, Complaint ¶ 42 (E.D.N.Y., filed Feb. 8, 1990). The *ad damnum* in this Complaint was $300 million.

[30] FDIC also alleged in that case that, at a meeting with the bank examiners, the firm represented that efforts would be made to address the examiners' concerns about undue risks presented by the mortgage servicing assets but failed to disclose to them its awareness that the bank had already entered into an agreement for the purchase of an additional mortgage servicing portfolio from another party. *Id.* ¶¶ 84-85. Assuming that this purchase was a normal and lawful transaction when entered into, the duty to disclose it to the examiners not only is not contemplated under current standards of professional responsibility but is affirmatively prohibited. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.6 (1983).

[31] Eckert Seamans Complaint, note 29 *supra*, ¶ 120(h) (emphasis supplied).

Indeed, to suggest that an attorney-client relationship with a depository institution (or any corporate entity, for that matter) also entails representing some other closely identified group such as the directors, the officers, the shareholders, the depositors, or the creditors not only creates an innate conflict of interest in every case but also, and more fundamentally, ignores the separate juridical existence of the institution.[32]

Taking the concept even further, officials of the Office of Thrift Supervision (OTS) have asserted that outside counsel to a thrift institution owe a *fiduciary duty* to the federal government because of, variously, the "negative equity interest" the government holds in the institution (*i.e.*, the government as a kind of stockholder), the size of the government's stake (as the single largest creditor) in the event the institution fails, "hornbook" insurance law that an insurer who covers a loss is subrogated to the rights of the insured, and a duty of counsel to practice the "whole law." Provisions implementing this duty to the government can be found in the consent orders with the OTS signed by various law firms, including the highly publicized, $41 million Kaye, Scholer settlement of a $275 million claim.[33]

The ethical dilemmas for an IDI's counsel that simultaneously owes a duty to the client and the government can be illustrated in the most common factual setting,

[32] For examples of novel theories in other receivership cases, *see Task Force Report*, note 5 *supra*, at Part V.

[33] *See* Stephen Labaton, *Lawyers Agree to Pay Big Fine in S&L Case*, N.Y. Times, Mar. 9, 1992, at A1; Sharon Walsh, *Law Firm Settles S&L Complaint; Pact With Regulators Calls for $41 Million Payment Over 5 Years*, Wash. Post, Mar. 9, 1992, at A1. For critiques of OTS's theories and these consent order provisions, *see generally* Lawrence G. Baxter, *Fiduciary Issues in Federal Banking Regulation*, 56 LAW & CONTEMP. PROBS. 7 (1993); Keith R. Fisher, *Nibbling on the Chancellor's Toesies: A "Roguish" Concurrence with Professor Baxter*, 56 LAW & CONTEMP. PROBS. 45 (1993).

where counsel is engaged to prepare loan documentation. In this situation, counsel has been engaged for a specific purpose and is neither hired, nor in most cases qualified, to serve as regulatory counsel. Yet, if one imposes an open-ended duty to investigate, counsel might be obliged to

- ascertain whether the loan was a bona fide transaction and not a sham;[34]
- investigate the borrower and his related interests to determine whether the loan violated any of the myriad of regulatory requirements, such as restrictions on loans to insiders and their related interests, limitations on loans to one borrower, or antitying restrictions;[35]
- evaluate the IDI's financial records to determine whether it has adequate capital to book this asset;[36]
- independently evaluate the creditworthiness of the borrower, the purpose of the loan, and the adequacy of the collateral, to ascertain whether making the loan would be an unsafe or unsound practice;[37]
- determine, if the loan is secured by real property, whether the IDI has obtained an adequate and

[34] *Cf. FDIC v. Shrader & York*, 991 F.2d 216, 219 (5th Cir. 1993); *FDIC v. Bauman et al.*, No. CA3-90-614-H, Complaint ¶ 68 (N.D. Tex., filed Mar. 19, 1990).

[35] *See, e.g.*, 12 U.S.C. §§ 84, 375a, 375b, 1972; 12 C.F.R. Parts 31, 32, 215.

[36] *See, e.g.*, 12 C.F.R. Part 208, App. A-B. As lawyers are not by training or experience competent to perform this financial analytical task, the *reductio ad absurdum* would be for the law firm to hire its own accounting firm to audit the client's books.

[37] *Cf.* 12 U.S.C. § 1818(b)(1), (e)(1)(A)(ii), (i)(2)(B)(i)(II) (possible enforcement sanctions for engaging in any unsafe or unsound practice).

> independent appraisal[38] and whether the IDI has in place adequate written policies and procedures for real estate lending;[39]

That the firm has not been engaged to perform (and is not competent to perform) all of that work, and that the client may be unwilling to pay for it (or, worse yet, may become irritated enough at the thought to sever the relationship), are, of course, fundamental issues going to the heart of any duty to investigate. It almost goes without saying that having this sort of work done by a law firm is frightfully expensive.[40]

Imposing on regulatory lawyers a duty to the government would result in equally expensive but considerably more deleterious consequences, for it would impair that independence and detachment which are one of the principal values of the attorney-client relationship. In view of the complex skein of statutes and regulations governing IDIs and their affiliates, bank regulatory lawyers serve an important function assisting their clients in new product

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[38] *See, e.g.*, 12 C.F.R. Part 34.

[39] *See, e.g.*, 12 C.F.R. Part 208, App. C.

[40] Some important limitations on a duty to investigate may be found in the ABA's *Statement of Policy Regarding Lawyer's Responses to Auditor's Request For Information.* This Policy Statement provides in pertinent part that a lawyer's response to an auditor's inquiry "is properly limited to matters which have been given substantive attention by the lawyer in the form of legal consultation, and, where appropriate, legal representation." There is simply no duty to investigate "legal problems of the client, even when on notice of some facts which might conceivably constitute a legal problem." As further explicated in the commentary to this provision, a lawyer's response "should not include information concerning the client which the lawyer receives in another role." *See, e.g., Tew v. Arky, Freed, Stearns, Watson, Greer, Weaver & Harris, P.A.*, 655 F. Supp. 1573, 1574 (S.D. Fla. 1987) (no duty to advise auditors of client's financial problems, even though member of law firm attended meeting at which client's impending insolvency was discussed).

development and other innovations. Our balkanized system of depository institution regulation has long encouraged the identification and exploitation of what are disparagingly referred to as "loopholes." Many of these "loopholes" have proved essential in enabling the banking industry to keep pace with market developments. They also reflect deliberate compromises by Congress, which, of course, retains plenary power to plug loopholes it later finds undesirable. Some of the more well-known "loopholes" identified and exploited by sophisticated regulatory counsel in recent years have included

- the creation of "nonbank banks" by exploiting a loophole in the pre-1987 definition of "bank" in the Bank Holding Company Act, *see Board of Governors v. Dimension Fin. Corp.*, 474 U.S. 361 (1986);[41]
- construction of the Federal Deposit Insurance Act to permit the offering of federally insured brokered deposits, notwithstanding efforts by FDIC and the Federal Home Loan Bank Board to prohibit such practices by regulation, *see FAIC Securities, Inc. v. United States*, 768 F.2d 352 (D.C. Cir. 1985);
- permitting banking organizations to diversify into the securities business with the creation of bank securities affiliates engaging in underwriting and dealing in all manner of securities by exploiting a loophole in the Glass-Steagall Act, *see Securities*

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[41] In *Dimension*, this Court admonished the Federal Reserve Board to police only within the bounds of its statutory authority and not usurp the legislative function by trying to correct perceived flaws in the statute it administers. The "nonbank bank" issue also serves as a good example of Congress' power—and readiness—to make such adjustments. In the Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, 101 Stat. 552 (1987), at the urging of the Federal Reserve, Congress plugged the nonbank loophole by changing the statutory definition of "bank" in the Bank Holding Company Act.

Indus. Ass'n v. Board of Governors, 900 F.2d 360 (D.C. Cir. 1990); *Securities Indus. Ass'n v. Board of Governors,* 839 F.2d 47 (2d Cir.), *cert. denied,* 486 U.S. 1059 (1988); and

- the use of State law to permit bank holding companies to engage indirectly in various aspects of the insurance business, conducted through a bank rather than a nonbank subsidiary, to avoid a prohibition against such activities in the Bank Holding Company Act, *see, e.g., Citicorp v. Board of Governors,* 936 F.2d 66 (2d Cir. 1991); *Independent Ins. Agents of America, Inc. v. Board of Governors,* 890 F.2d 1275 (2d Cir. 1989), *cert. denied,* 498 U.S. 810 (1990).

Some of these examples were bitterly contested by the agencies. The private parties all prevailed in court, but, had they not, it would not have been possible at the conclusion of the court battle for the agencies to initiate actions against counsel. The chilling effect on counsel of any manufactured federal common law duty that might lead to a contrary result is self-evident.

Lest there be any misunderstanding, nothing in this brief should be read to suggest that a lawyer may ignore, counsel, or assist violations of law or criminal or fraudulent conduct by the client, or that a lawyer may assume an ostrich-like posture and close his or her eyes to facts and circumstances which a reasonably prudent person would deem suspicious. Existing State ethical rules and principles of professional liability deal adequately with those issues. But it must be remembered that the duty imposed by the court below arises *despite the lack of any basis for suspicion.* The court is, in effect, allowing the government to deputize the private bar to do the supervisory job the regulatory agencies themselves should be doing. That is bad banking law and bad policy.

Such an open-ended rule is inappropriate. Even with respect to a matter that is unquestionably within the

scope of the lawyer's engagement, the extent of the inquiry, if any, that counsel should make ought not to be a rule of general applicability but ought instead to depend upon (A) the nature of the facts within counsel's personal knowledge or professional experience and (B) whether, based on such facts, reasonably prudent counsel should know or suspect that something is amiss.[42] The danger of an unqualified duty to investigate is that it effectively transforms counsel into an insurer of his client's good faith or of the accuracy of the facts represented to him by the client.

C. Malpractice Insurance Consequences

The impact of decisions such as the Ninth Circuit's in the instant case on the availability, cost, and coverage of legal malpractice insurance has been predictable. For several years now, most insurers have required that all renewing or prospective insureds submit supplemental information about the nature and extent of the firm's representation of financial institutions, including identification of the individual clients. This detailed information is used by the insurers not only to underwrite but also to reserve claims. Some insurers even take this information and independently research the solvency of each listed IDI client.

Some insurers are simply declining coverage (or quoting premiums so high as to be tantamount to declination) for firms with significant representation of financial institution clients. Other insurers are variously excluding coverage for claims brought against a law firm by the regulators, for the firm's banking practice entirely, for claims arising out of legal work performed for specifically identified IDIs, or for claims arising out of legal work performed by identified lawyers in the firm (*i.e.,* those

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[42] For a helpful discussion of these principles in the securities law context, see Judge Friendly's opinion in *SEC v. Frank,* 388 F.2d 486 (2d Cir. 1968).

who represent IDIs). Where coverage is available, the policies exhibit increased premiums, increased deductibles, lower per claim and aggregate limits, or sublimits, well below the general policy limits, for claims arising out of financial institutions work. *See generally Working Group Report* at 48-53, 266-271.

The consequent impact on the cost and availability of legal services to IDI clients is also predictable. Even if the proliferation of claims against law firms does not, of itself, drive a number of firms currently providing legal services to IDIs out of the market, the increasing cost and diminishing availability of malpractice insurance may lead to that result. Those firms that remain will, of necessity, be forced to charge higher fees for such services and may well find it prudent not to represent IDIs in financial difficulty or with low net worth because of the increased risk of failure and subsequent searching by the receiver for every "deep pocket." Ironically, therefore, the very clients that need quality legal services the most may often be unable to find them or afford them if found. And those IDIs that can afford such services will simply pass the costs on in the form of lower interest rates on deposits, higher fees for banking services, and higher interest rates on loans. The long-term, deleterious effects on the banking industry and on consumers of financial services will far outweigh any short-term benefit to taxpayers from enrichment of FDIC's coffers.

CONCLUSION

The selection of a rule of decision according to whether a particular litigant can maximize its recoveries is not an appropriate criterion for resolving the rights and responsibilities of parties acting under an impartial body of rules. The underlying cause of action in this case was created under State law and brought by FDIC as receiver for a failed, state-chartered bank. Nothing in the Federal Deposit Insurance Act or in this Court's jurisprudence justifies the creation of a federal common law duty of counsel to investigate, and the implications of imposing such a duty to the government demonstrate beyond cavil that it is bad law and bad policy. The decision of the court of appeals should be reversed.

Respectfully submitted,

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